

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

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Refer Reply To:

CC:PSI:B09

PLR-160817-05

Date:

June 15, 2006

Legend:

Sister 1	=
Sister 2	=
Father	=
Mother	=
Trust	=
Settlement Agreement	=

Court	=
State	=
State Statute 1	=
State Statute 2	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=

Dear :

This is in response to your letter dated November 28, 2005, and subsequent correspondence, requesting rulings on the gift and generation-skipping transfer (GST) tax consequences of certain proposed modifications to a trust.

In Year 1, before 1985, Trust was formed by Sister 1 and Sister 2, their then husbands, and their parents (Father and Mother). Sisters have since divorced and remarried. Sister 1, Sister 2, and Father and Mother (collectively, Settlers) funded Trust in Year 1 with cash, intangibles, and their respective interests in certain minerals and ranch lands.

Sister 1 and Sister 2 funded one-third of Trust and Father and Mother funded two-thirds of Trust. Father and Mother died in Year 2 and Year 3, respectively, (both prior to 1985), and Trust became irrevocable in Year 2. The last contribution to Trust was made in Year 3, and consisted of the residue of Mother's estate.

Section I(a) of Trust provides, in relevant part, that upon the death of Mother and Father, the net income of Trust is to be distributed one-half each to Sister 1 and Sister 2. Upon the death of either sister, the deceased sister's share of the income may be used to benefit the children and lineal descendants of the deceased sister or accumulated and distributed to these persons upon the termination of Trust.

Section I(b) provides that in the event the trustee determines the net income of Trust to be insufficient to maintain and support Sister 1 and Sister 2 or their children and lineal descendants in their accustomed manner of living, the trustee may invade trust corpus to make up the deficiency. Further, in the event the executor of a Settlor's estate so requests, the trustee is to invade the trust corpus contributed by the Settlor to pay the estate and other taxes of the Settlor. In the event Trust corpus is invaded:

... such reduction shall be reflected in the beneficial ownership and such share shall sometimes hereinafter be referred to, for example, as adjusted one-half (1/2) or other appropriate reference, such distributions to be reflected in ownership regardless of whether such reference has been made. Furthermore, to the extent such invasion materially affects the income attributable to the initial contribution of a Settlor, the trustee shall make appropriate adjustments to the relative income distributable under [Section I(a)].

Section I(c) provides that during his lifetime, Father, with the concurrence of either Sister 1 or Sister 2, may revoke, alter, and amend Trust and distribute the assets of Trust to the Settlers in the same proportion as the original contributions by each of the Settlers, taking into account any adjustments under Section I(b). In the event Sister 1 or Sister 2 is deceased, that portion of Trust that would have been distributed to the deceased sister is to be distributed in equal shares to her children and lineal descendants.

Section I(d) provides Mother and Father with a limited power to appoint up to one-third of Trust's assets, one-half of this amount among the group consisting of Sister 1 and her lineal descendants and one-half among the group consisting of Sister 2 and her lineal descendants.

Section I(e) provides that Trust may be terminated under certain circumstances if the termination would best serve the intended purpose of Trust. In the event of such termination, Sister 1 and Sister 2, if living, and if not their children and lineal

descendants of any deceased child are to receive one-half of Trust's assets adjusted by Sections I(b), (d), and (f).

Section I(f) provides that each sister has a limited power to appoint an "adjusted one-half (1/2)" of Trust's assets among her children and lineal descendants. The fractional share of the assets over which each sister has a power of appointment is to be adjustment pursuant to Sections I(b) and (d). If either sister dies without exercising her power of appointment, her adjusted one-half (1/2) share is to be distributed in equal shares to her children and lineal descendants. In the event, either sister dies without surviving lineal descendants or lineal descendants who do not survive until the termination of Trust, her share of Trust assets is to be held in trust for the benefit of the surviving sister and her children and lineal descendants.

Section I(h) provides that Trust will terminate no later than 21 years after the death of the survivor of the Settlers, and the children, lineal descendants, and spouses of the sisters alive on the date Trust was created.

Section I(j) provides, in part, that the trustee has the power to determine the manner in which expenses are to be borne and in which receipts are to be credited as between principal and income.

Sister 2 filed bankruptcy in Year 4. As a result of judicial proceedings, assets contributed by Sister 2 to Trust were removed from Trust and became part of Sister 2's bankruptcy estate.

A dispute arose between Sister 1 and Sister 2 as to whether certain costs and expenses incurred by Trust in connection with the bankruptcy should be treated as distributions under Section I(b). The terms of Trust do not specifically address the allocation of assets and/or expenses and the division of Trust into shares after one Settlor's contribution to Trust is involuntarily distributed in a bankruptcy proceeding, thus creating an ambiguity. Each party to Settlement Agreement has interpreted the terms of Trust to support opposing results.

As a result of this dispute, trustee filed a suit for declaratory action in Year 5, and through the process of mediation ordered by Court, the parties have entered into Settlement Agreement, which was approved by Court in Year 6. It has been represented that all beneficiaries of Trust, including unborn and contingent beneficiaries, were represented by legal counsel in the negotiation of Settlement Agreement.

In general, Settlement Agreement provides that Trust is to be divided into two separate trusts, one trust to benefit Sister 1 and her descendants and one trust to benefit Sister 2 and her descendants. The terms of the resulting trusts will be the same as Trust. The assets contributed to Trust in Year 1 by Sister 1 are to be allocated to Sister 1's trust.

The remaining assets of Trust and the costs of all litigation are to be allocated equally between the two resulting trusts.

Trustee has requested a ruling that the division of Trust into two separate trusts and the allocation of Trust's assets between the resulting trusts based upon Settlement Agreement:

(1) will not cause any beneficiary of Trust or the resulting trusts to be deemed to have made a gift or to be subject to gift taxes under chapter 12 of subtitle B of the Internal Revenue Code; and

(2) will not cause Trust and the resulting trusts to lose their status as exempt from the GST tax by reason of § 1433(b)(2)(A) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations.

Law and Analysis:

Ruling 1:

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations states that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes, depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. United States, 674 F.2d 761, 774-75 (9th Cir. 1981) citing Commissioner v. Estate of Bosch, 387 U.S. 456, 87 S. Ct. 1776, 18 L. Ed. 2d 886 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Internal Revenue Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

State Statute 1 provides, in part, that a person interested as or through an executor or administrator, trustee, guardian, other fiduciary, creditor, devisee, legatee, heir, or next of kin in the administration of a trust may have a declaration of rights or legal relations in

respect to the trust to direct the executors, administrators, or trustees to do or abstain from doing any particular act in their fiduciary capacity or to determine any question arising in the administration of the trust including questions of construction of wills and other writings.

State Statute 2 provides, in part, that on petition of a trustee or a beneficiary, a court may order that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, or that the trustee be prohibited from performing acts required by the terms of the trust, if: (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; or (2) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust. The court will exercise its discretion to order a modification of a trust in the manner that conforms as nearly as possible to the intention of the settlor.

In this case, a bona fide controversy existed concerning the administration of Trust. Specifically, Sister 1 and Sister 2 disagreed as to whether certain costs and expenses paid by Trust relating to Sister 2's bankruptcy should be treated as distributions under Section I(b). To resolve the dispute, the parties have entered into Settlement Agreement, which was approved by Court in Year 6. During the negotiations that lead to the agreement, all of the beneficiaries of Trust, including unborn and contingent beneficiaries, were represented by legal counsel.

Under the terms of Settlement Agreement, Trust is to be divided into two separate trusts, one trust to benefit Sister 1 and her descendants and one trust to benefit Sister 2 and her descendants. The terms of the resulting trusts will be the same as Trust. The assets contributed to Trust in Year 1 by Sister 1 are to be allocated to Sister 1's trust. The remaining assets of Trust and the costs of all litigation are to be allocated equally between the two resulting trusts.

The terms of Settlement Agreement are reflective of the rights of the parties under applicable State law that would be applied by the highest court of that state. Accordingly, based on the facts submitted and the representations made, we conclude that implementation of Settlement Agreement will not cause the parties to the agreement to have made a taxable gift for purposes of the federal gift tax under § 2501.

Ruling 2:

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986. A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1433(a) of the Act and § 26.2601-1(a), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the regulations, the GST tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if – (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

In the present case, Trust was irrevocable on September 25, 1985 and no additions, actual or constructive, have been made to Trust after that date.

As discussed above, a bona fide controversy existed concerning the administration of Trust. State Court has the authority to modify the terms of a trust to comport with a Settlor's intent. Under the agreement approved by the Court, Trust will be divided into two trusts, one for the benefit of Sister 1 and her descendants and one for the benefit of Sister 2 and her descendants. In addition, the costs of all of the litigation will be allocated equally between the two resulting trusts. During the negotiations that led to Settlement Agreement, all of the beneficiaries of Trust, including unborn and contingent beneficiaries were represented by legal counsel. We believe that the terms of Settlement Agreement are within the range of reasonable outcomes under the governing instrument and applicable state law. Settlement Agreement is a compromise between the litigating positions of each sister and their respective families and reflects their assessments of the relative strengths of their positions.

Accordingly, based upon the facts submitted and the representations made, we conclude that the division of Trust into two separate trusts and the allocation of Trust's assets between the resulting trusts based upon Settlement Agreement will not cause Trust and the resulting trusts to lose their status as exempt from the GST tax by reason of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed or implied concerning the inclusion of part or all of Trust or the resulting trusts in the estates of either Sister 1 or Sister 2 under § 2036. The Office of Chief Counsel for Income Tax & Accounting has declined to rule on the income tax consequences of the modification discussed herein.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

James F. Hogan

James F. Hogan
Office of the Associate Chief Counsel
Senior Technician Reviewer, Branch 9
(Passthroughs & Special Industries)

Enclosures:

Copy for § 6110 purposes

cc: